
To Subsidize Development or Not?

Often-uninformed city leaders struggle with the decision, and taxpayers pay the price for their lack of financial knowledge.

These days it's not hard to convince people to live downtown, or, for that matter, to get developers to build places for them to live. Increasingly, both millennials and baby boomers want urban amenities. They want to live close to work, parks and restaurants, and they want to be able to walk or bike to them. As a result, downtown populations have soared: 65,000 people now live in downtown Seattle, downtown Los Angeles — traditionally not a residential area — is home to 52,000 people, downtown Philadelphia has 57,000, and Boston has 17,000 (a 50 percent increase since 2000).

Needless to say, these cities aren't subsidizing downtown development. In some cases, they've actually started to extract fees and concessions from developers to build downtown. But that's not the case everywhere.

In Houston, where I live, 150,000 people work downtown, but fewer than 5,000 people live there. Clearly, it has room to grow — and there are takers. Several thousand luxury units are currently under construction. Rentals can go for close to $5,000 per month, while condominiums can go for as little as $300,000 or as much as $1 million or more. But the market for downtown living isn't as robust as in other cities. So Houston is paying developers $15,000 a unit to build there.

Which raises some pretty basic questions: How much should cities spend to buy downtown residents? And when should they stop?

Yes, I said "buy" residents. When city leaders provide a financial subsidy for a development, that's what they are doing — paying money to acquire residents or stores or offices that wouldn't otherwise be built in a certain place.

The obvious answer to when a city should stop buying residents is when developers stop asking for subsidies. But we know all too well that this never happens. Urban real estate developers always ask for subsidies whether they need them or not, and cities often provide them even when they're not needed. Why else would cities subsidize billion-dollar sports stadiums to house teams that are worth billions and that are owned by sports tycoons worth billions?

That's why cities need to know a lot about the economics of private real estate development deals, specifically when and why projects pencil out or don't. It's something that, amazingly, cities know little about. If you're going to subsidize a developer, for example, you should only do it when you know you can't get the project you want done any other way. Alternatively, if you're going to soak a developer for impact fees or other community benefits, you should do so only when you know it won't kill a project you otherwise want. That's why cities should have a lot of financial analysis capacity — not just to balance their own budgets, but to understand whether developers are balancing their own budgets on the backs of the taxpayers.

So perhaps the real question is: How do cities ensure they have the financial IQ to decide when and when not to subsidize development?

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